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SUBJECT: BULGARIA'S FIRST EU BUDGET CONTINUES FISCAL DISCIPLINE

Ref Sofia 1495

¶1. (U) SUMMARY: Parliament approved the 2007 state budget on December 19 - Bulgaria's first as a full EU member state. It is a fiscally disciplined plan with an expected surplus of 0.8 percent of GDP (well above the Maastricht requirement of a 3 percent deficit or better for Euro entry.) This conservative stance - with Bulgaria's traditionally understated revenue estimates - is likely to lead to budgetary over-performance again as well as a relatively high government share of the domestic economy. Local business has praised the reduction of the corporate tax to 10 percent, and after intense debate within the ruling coalition, the defense budget will be 2.5 percent of GDP in order to meet NATO obligations. Still a concern to the IMF and others is the high current-account deficit - projected at 11.8 percent of GDP next year by the government and around 15 percent by the IMF. END SUMMARY

ANOTHER SURPLUS BUDGET/GROWTH OF GOVERNMENT CONTINUES

¶2. (U) The 2007 budget maintains fiscal discipline through a surplus of 0.8 percent of GDP, following an expected 3.5 percent surplus at end-2006. The 2007 budget is based on expected real GDP growth of 5.8 percent due to increases in investment and exports, and expected annual inflation of 4.4 percent. Investment is expected to reach 23 percent of GDP in 2007. The Ministry of Finance predicts that sustained growth in exports and weaker import growth should narrow the current-account deficit to 11.8 percent in 2007 from a government estimated 14 percent in 2006 (the IMF claims the gap may reach 15 percent both this year and next). The 2007 budget will continue to support a relatively high government share of the economy with revenues and expenditures of 41.7 and 40.9 percent of GDP, respectively. Despite the budgeted 0.8 percent surplus, the government - after talks with the IMF - agreed to aim for a 2 percent surplus by year-end using revenues that it hopes will be larger than estimated.

REVENUES UNDERSTATED/RECORD LOW CORPORATE TAX RATE

¶3. (U) The government has continued its conservative practice from previous years of projecting low revenues, which is likely to lead to budgetary over-performance in 2007. Critics complain this harms parliament's ability to give proper budgetary oversight, while others claim it is the best way to ensure a sizable surplus (and in some years, extra end-of-year funds for the government's pet projects). Planned tax revenues will grow 16.3 percent to reach BGN 17.5 Billion (USD 11.8 Billion). Recognizing the need to stimulate the private sector for higher investment and employment, the GOB reduced the corporate tax rate by 5 percentage points to an EU-low 10 percent (Ref A). By lowering the corporate tax rate, the GOB hopes to transfer part of the grey sector to the regular economy and increase tax collections, as well as give Bulgaria a more effective tool in recruiting foreign companies.

EXCISE TAXES RISE

¶4. (U) The government increased excise taxes on tobacco, alcohol, coal and fuel, mainly to harmonize with EU tax policies. The GOB argued that this increase is taking place ahead of a pre-agreed time schedule because of its efforts to temper inflationary pressures before (projected 2010) Eurozone entry. According to the Finance Ministry, the rise in excise taxes will increase the annual inflation rate 0.3 percentage points and will not pose a threat to financial and macroeconomic stability. The GOB recognizes possible reductions to the budget from lower VAT collection following EU entry. The suspension of customs duties in intra-community trade, particularly at the Greek and Romanian borders, has led the government to estimate reduced VAT revenues by BGN 450 Million (USD 300 Million) next year. Possible VAT fraud due to slower integration of EU tax practices may incur additional VAT losses of BGN 550 Million (USD 370 Million).

GENEROUS EXPENDITURES IN SOCIAL SECURITY

¶5. (U) Current expenditures will go up 10.7 percent - a significant increase of BGN 1.6 Billion (USD 1.1 Billion) - to reach BGN 16.5 Billion (USD 11.2 Billion) in 2007. Capital expenditure will grow 23 percent to reach BGN 2.7 Billion (USD 1.8 Billion). As in the previous year's budget, social security will draw most of the public funds - 33 percent out of total expenditures - followed by defense and security (13.4 percent), public investment and services (12.3 percent), health care (10.9 percent), and education (10.5 percent). Pensions will be increased by 8.5 percent from July 1 2007. The minimum monthly age pension will go up from BGN 85 (USD 57) to BGN 92.23 (USD 62.32). The highest pension will reach BGN 490 (USD 330). Public-sector salaries will rise by 10 percent despite the IMF recommendation for a lower increase.

MONEY FOR DEFENSE AND HEALTH SPARKED DISAGREEMENT

¶6. (U) Defense spending created disagreements within the ruling coalition. Defense Minister Bliznakov grounded his ministry's call for increased spending on obligations to modernize the military under NATO. After protracted negotiations, the 2007 budget will allow defense expenditures estimated at 2.55 percent of GDP. Health care expenditures will be BGN 2.22 Billion (USD 1.5 Billion) or 4.33 percent of GDP. This has sparked vocal protests inside professional groups. Medical associations contend this is not enough to guarantee quality health services and provide a much-needed modernization of the sector.

2007 BUDGET - THE FIRST EU BUDGET

¶7. (U) Finance Minister Plamen Oresharski described this first EU-era budget as one of Bulgaria's EU integration that will provide an effective start in the absorption of EU funds. Oresharski also said the budget will aim at securing greater employment and a higher standard of living for all Bulgarian citizens. The government will pay its first annual EU budget contribution, estimated in 2007 at BGN 634 million (USD 430 million).

IMF CONCERNS UPON THEIR DEPARTURE

¶8. (U) During their fourth and final visit in December, the Head of the IMF mission, Robert Hagemman, commended the 2007 budget as adequate and prudent. The IMF remains concerned with the budgetary risks related to the cut in the corporate tax rate and the increase in public sector wages. The IMF will continue to insist on conservative implementation of the 2007 budget and at least a two percent fiscal surplus to cover against risks of low tax revenue collection. The Fund is also worried about the high current account deficit and urges authorities to maintain their restrictive fiscal stance even after its departure. After March 2007, when the agreement with the GOB officially expires, the IMF will provide only technical assistance upon request.

COMMENT:

¶9. (SBU) Over the past three years, the government has fairly

closely followed IMF recommendations for tight spending and surplus budgets. Politicians have invoked the specter of the IMF to reduce spending, control inflation, promote economic growth, and give confidence to international markets. The government has been successful in these efforts, and is further ahead than many other countries in qualifying for Euro entry - which will not happen until 2010 at the earliest. Upon the IMF's departure from Bulgaria, the goal of Euro entry is the next carrot to force politicians to continue the virtuous fiscal practices of the past two governments. While the current account deficit and an increasing inflation rate (the only potential pitfall to early Euro adoption) are notable macro problems, the GOB has done a very commendable job of keeping its fiscal house in order.
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